Latin America the morning after

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Abstract:
In the first half of the 1990s, Latin America exhibited signs of an impressive economic transformation. New economic policies eliminated many of the debilitating symptoms that had long crippled the region. While their effects varied among countries, the reforms often dealt swiftly and effectively with high inflation, stagnation, poor international creditworthiness, low exports, currency instability, and chronic capital flight. While the reforms have yet to improve the core problems of the region significantly, they did accomplish a striking set of positive changes that, in the wake of the Mexican crisis, may be as easily overlooked as the core problems were in the previous euphoric stage. Of all Latin America's economic changes, the boom in foreign investment was the most dramatic and visible to the outside world.

Full Text:

EUPHORIC PERCEPTIONS, FRAGILE REALITIES

BEWILDERED BY the bizarre turn of events in Mexico, novelist Gabriel Garcia Marquez told his colleague Carlos Fuentes that they should throw their books into the sea. "We have been totally defeated by reality," said Garcia Marquez.

If Latin American realities defeat novelists with the magical imagination of Garcia Marquez, foreign investors and policymakers are much easier prey. In mid-1994, the Financial Times warned that, "For those that think of Latin America in terms of generals, jungles, and sackfuls of worthless currency, it may be a time to overhaul some myths. Things have changed. South America's soldiers have long since goose-stepped back to the barracks, their power usurped by squadrons of technocrats and battalions of economic miracle-makers." Less than six months later, however, the same newspaper informed its readers that "Mexico's currency crisis has dimmed expectations for economies throughout Latin America.... The crisis and the border war which flared up in January between Peru and Ecuador have raised some fundamental questions in the minds of investors about the wisdom of investment in Latin America. Given the losses they have suffered, some may well retire from the region for good."

It is hard to imagine a more drastic and rapid change of perceptions. In the first half of the 1990s, Latin America exhibited signs of an impressive economic transformation. New economic policies eliminated in any of the debilitating symptoms that had long crippled the region. While their effects varied among countries, the reforms often dealt swiftly and effectively with high inflation, stagnation, poor international creditworthiness, low exports, currency instability, and chronic capital flight. The adoption of these policies coincided with unique circumstances in international financial markets and led investors to respond enthusiastically to the new opportunities in Latin America. Ironically, however, the massive inflow of foreign money was a mixed blessing. It helped speed up reforms and defrayed their costs, but it also masked some of the deeper sources of Latin America's poor economic performance, lowered the urgency of dealing with them, and created new problems. The success in tackling inflation, the unprecedented growth in trade among neighboring countries, and the euphoria of foreign investors obscured the drag on the region's economic prospects created by high income disparities, low productivity, low international competitiveness, and--most important of all--ineffectual public institutions. Governments easily postponed giving attention to these structural problems; likewise, foreign investors gave them only passing notice. After all, governments could not deal with such woes effectively without first eradicating some of their most visible and debilitating symptoms. It is hard, for example, to increase savings or boost competitiveness in the midst of hyperinflation. It was easy, however, for foreign portfolio investors not to pay too much attention to underlying fundamentals. They operated with short time horizons and enjoyed extraordinary international mobility, which lowered the risks of investing before deeper structural changes were made. Nonetheless, while the reforms have yet to improve the core problems of the region significantly, they did accomplish a striking set of positive changes that, in the wake of the Mexican crisis, may be as easily overlooked as the core problems were in the previous euphoric stage. In thinking about Latin America, gloom can be as disorienting as excessive optimism.

THE EUPHORIC EARLY 1990s

THE POSITIVE and irreversible changes induced by the economic reforms of the early 1990s should not be underestimated. Trade liberalization is forcing Latin American companies to become more efficient. State-owned companies that have been privatized can no longer drain national treasuries. The fiscal situation is radically better. Between 1985 and 1989, prior to the reforms, public expenditures in Latin America exceeded government revenues by about five percent of GDP. In contrast, since 1990--thanks to budget cuts, privatization, and improved tax collection--the region has had its public accounts either near balance or in surplus. As a result, 17 out of 22 countries in Latin America currently have single-digit inflation rates, and average inflation in the region (excluding Brazil, which began an adjustment plan in 1994) dropped from 130 percent in 1989 to 14 percent in 1994.

In another drastic break with the past, the widespread liberalization of trade caused average tariffs to drop from more than 50 percent in the 1980s to the low teens in the mid-1990s. Imports requiring a special government permit and quotas now tend to be the exception rather than the rule. Latin America's trade liberalization was initially adopted unilaterally by each country--that is, instead of negotiating trade concessions from their main trading partners, countries assumed that it was in their self-interest to lower their tariffs and eliminate trade barriers. In the beginning, the main force behind trade liberalization was economic crisis, not regional integration. Dismal economic performance and political change had weakened the business, labor, military, and political coalitions that traditionally supported protectionist policies. Armed with a new worldview and the political capital provided by constituencies willing to swallow bitter medicine in the face of impending economic debacles, new administrations were able to smuggle trade liberalization into their overall macroeconomic stabilization programs.

A virtual free trade zone emerged spontaneously, and trade among neighbors soared, becoming an important force for growth. Argentina and Chile have tripled their trade with one another in the past three years. Brazil and Argentina have done the same, and Brazil is now Argentina's biggest trade partner. On a broader scale, Latin exports to other Latin destinations have increased by 135 percent between 1986 and 1992. Between 1991 and 1994, trade among the region's 11 largest economies grew by 50 percent.

Freer trade has also spurred an unprecedented wave of cross-border investments. In 1991, Chilean investment in Argentina was less than $100 million; by 1994, it had jumped to $2.7 billion. Brazilian investment in neighboring countries is also on the rise, and private investments between Venezuela and Colombia and between Chile and Peru are at an all-time high. Seizing the opportunity, countries signed integration treaties with their neighbors that sought to lock in and further their newfound economic ties. Latin America is now crisscrossed by 30 free trade agreements that bind together pairs or groups of countries.

But of all Latin America's economic changes, the boom in foreign investment was the most dramatic and the most visible to the outside world. During the 1980s, foreign inflows of capital to Latin America were less than one percent of the region's GDP. In the 1990s, capital inflows increased to six percent of GDP. The flow of total private funds to the region went from $13.4 billion in 1990 to an impressive $57 billion in 1994. Foreign direct investment alone grew by 68 percent to $14 billion in 1991 and reached $22 billion in 1994. Between 1983 and 1989, about $300 million of Latin bonds were issued in international capital markets each year. In 1993 this figure jumped to $27 billion.

All these changes created favorable conditions for the resumption of economic growth, which had been stagnant throughout the 1980s. Average growth in Latin America between 1985 and 1989 was a scant 1.5 percent. Since 1990, yearly growth has averaged 3.5 percent.

Optimism about Latin America was not based only on dry statistics. Each month and, at times, each week, a positive and often unprecedented event grabbed headlines around the world. The privatization of the state-owned oil or telephone companies that used to be the sacred cows of economic nationalism the performance of Chile's pension funds, and the scores of Latin American companies joining the New York Stock Exchange all illustrated the region's turnaround.

The crowning event was the U.S. Congress' ratification of the North American Free Trade Agreement in 1993, a plausible first step toward the dream of creating a free trade zone comprising the entire western hemisphere. Shortly after NAFTA'S passage, President Clinton called for a hemispheric presidential summit to discuss the expansion of free trade in the hemisphere. The summit convened in Miami in early December 1994. "The so-called lost decade in Latin America is a fading memory," Clinton said in his opening speech. "These reforms are working wonders. These are remarkable, hopeful times."

Nine days later, the Mexican government devalued the peso, and the country plunged into an economic nosedive from which it will take years to recover. The Mexican crash destabilized currencies and financial markets around the globe. Latin America was not spared. Even Chile, which had impeccable fiscal credentials and enviable economic fundamentals, saw its stock market drop 12 percent in the first quarter of 1995. Brazil and Argentina were prime suspects to be the next Mexico. Euphoric international investors who had been singing the praises of Latin America just weeks earlier felt disenchanted and even betrayed by those who sold them on the region. In Latin America, confusion about the present and fear about the future returned as themes at cabinet meetings and family gatherings.

ANATOMY OF A BOOM

As SURPRISING as the dramatic swing in the perceptions of international investors about Latin America is, the region's vulnerability to such swings is even more surprising. Latin America's economic performance this decade was shaped as much by changes in the world financial markets as by regional economic reforms. The economic liberalization of Latin America coincided with the accelerating trend of individuals and institutions in industrialized countries buying stocks and bonds instead of depositing their savings in banks. In a related trend, investors began to place an unprecedented proportion of their portfolios outside their home country. In 1993 alone, U.S. investors bought more foreign equities--about $68 billion--than in the whole decade of the 1980s. A portion of these investment portfolios went to the financial markets of countries that had recently opened to foreign investors, offered high interest rates, and had either eliminated or relaxed foreign exchange controls, thus making it easier for investors to move funds in and out of the country. Since 1990, private capital flows to developing countries increased five-fold, driving up the prices of equities and other financial instruments and making emerging markets even more attractive. In 1993, emerging markets' equities had their best performance ever, rising by 64 percent. Hence, soon after the economic reforms throughout the hemisphere, Latin American stock markets became stars in the international financial firmament. Each year between 1989 and 1994, one or more Latin American stock markets ranked among the world's best performers.

This flood of foreign money into Latin America could not have come at a better time. The liberalization of trade, the resumption of economic growth, and a steep increase in consumption induced a surge of imports that was not offset by exports, which grew at a slower pace. In 1994, for example, exports grew by 9 percent while imports increased by 12 percent. Thus, foreign investment became a powerful economic and political lubricant of economic change in the region. Without the inflows of foreign capital, the adverse consequences of continued trade deficits would have been felt more acutely by the population at large. Exchange rates would have depreciated more often, the drop in inflation might have been slower, and the rate of economic growth would have been lower. In contrast to East Asia, where foreign money was used mostly for investment, in Latin America it was used to finance a major expansion in consumption, which had been severely constrained during the 1980s. Thus, foreign investment greatly helped governments by lowering the political costs of implementing the reforms.

Foreign capital, however, was not a costless lubricant of market reforms. The relative abundance of foreign currency provoked by the massive inflows of foreign investment increased the value of the local currency. This overvaluation of the local money cheapened imports and made exports more expensive, thereby making it even more difficult to correct the trade imbalances of most countries in the region. In the first half of this decade, Latin American currencies appreciated by 24 percent and are currently about 35 percent stronger than they were at their weakest point during the mid-1980s.

Another problem with the capital flowing to the region was its composition. While direct foreign investment in factories, utilities, and mines was boosted by privatization and deregulation, a record-breaking portion of capital flowed in as foreign portfolio investment in stocks and bonds. Portfolio investment is always volatile, and in these days of electronically linked capital markets, it can leave a country literally at the speed of light.

Initially, the boom of foreign investment was widely interpreted as the response of financial markets to the new opportunities opened by the market reforms. This interpretation had to be revised when, in early 1994, the U.S. Federal Reserve began to increase interest rates. The expectation that interest rates in the United States would begin to climb diminished international portfolio investors' appetite for emerging markets' stocks and bonds. That expectation--reaffirmed by actual increases in the interest rate and combined with growing uneasiness about Mexico, the largest beneficiary of investments to emerging markets after China--led to a 14 percent drop in capital flows to Latin America in 1994. When Mexico crashed, foreign investors fled emerging markets, weaking havoc in the countries that had grown too dependent on them.

While Latin American economies have always depended on foreign capital, they recently developed an intense addiction to portfolio investment that made its slowdown especially destabilizing. That addiction was driven by the need to balance growing trade imbalances that led current account deficits to widen to tree percent of the region's GDP in 1994 from a pre-reform average of about one percent. Thus, the fortunes of market reforms in Latin America came to be closely correlated to the ebb and flow of international portfolios.

Two other characteristics of Latin America's economic reforms also help explain the euphoria of the early 1990s. First, the initial reforms mostly focused on changing the macroeconomic policy framework, and second, they required the dismantling of many existing public institutions. Both factors made it possible for the reforms to yield tangible macroeconomic results very quickly.

The main priorities of the new policies were to crush inflation, correct macroeconomic distortions, and promote exports. This usually meant eliminating government interference in the setting of prices, exchange rates, interest rates, and the allocation of foreign exchange and credit, as well as deregulation of the economy. It implied massive cuts in public budgets, privatization, and generally shrinking the state.

The reforms were healthy, unprecedented, and politically difficult. Despite their momentous consequences, such changes in the macroeconomic rules of the game are surprisingly simple to execute. Devaluing the currency, freeing prices, or liberalizing imports changes the daily lives of everyone in an immediate and visible way. Yet these market-oriented policies require neither a complex administrative apparatus nor the cumbersome revamping of entire ministries. On the contrary, they often mean the idling of many government agencies in charge of administering government controls. Above all, the success of these macroeconomic reforms in their initial dismantling stage was not dependent on the efficiency and commitment of the region's famously unreliable public bureaucracies. Thus, impressive results in aggregate statistics began to appear very quickly.

One place where they appeared was on the computer screens of money managers in New York, London, and Tokyo. Their screens showed countries that were rich in natural resources, bent on privatizing state-owned enterprises, welcoming foreign investors, and offering some of the highest interest rates in the world. Moreover, their currencies not only were freely convertible but grew stronger by the day as waves of foreign money poured in. This is the stuff of which the dreams of portfolio investors are made--especially of portfolio investors faced with the alternative of making three percent a year in their bank accounts in the United States.

Under these circumstances, it became easy to ignore the realities of the region and just follow the hype from companies selling Latin American securities and the media campaigns of governments boosting their international image. Journalists thrived on stories that showed the amazing contrasts of countries before and after their diet of market reforms. Many fund managers did not care much about the details underlying the region's turnaround. "We went into Latin America not knowing anything about the place," one of them noted after the Mexican crisis. "Now we are leaving without knowing anything about it."

TAKING A DEEPER LOOK

THE LATIN AMERICAN boom of the early 1990s was not just another financial bubble that finally burst once fickle portfolio investors lost interest in the region. The reforms induced important changes, many of them irreversible.

Perhaps as important as the progress in macroeconomic indicators is the shift in attitudes in Latin American policy circles. The need to maintain macroeconomic equilibrium, rid the state of many functions better performed by the private sector, and rely more on exports to propel growth has now become the mantra of many influential social groups throughout the region.

A concrete example of this shift in attitudes was the sharply contrasting ways in which governments in Latin America responded to the Mexican crises of 1982 and 1994. When Mexico defaulted on its international debts in 1982, the flow of external funds to the region suddenly came to an almost complete halt. Latin governments reacted by closing down their economies even more, tightening their grip on the private sector, imposing pervasive economic controls, and in some cases nationalizing banking systems. In 1995, the initial reaction of the Mexican, Brazilian, and Argentinian governments to the backlash produced by Mexico's crash was to deepen their market reforms, accelerate their privatization plans, boost their fiscal accounts, fine-tune their foreign exchange regimes, step up their efforts to promote exports, and strengthen their private banks. The commitment to these reforms will be severely tested in coming years, and Brazil and Argentina have combined their deepening of some reforms with a backslide in their trade opening. But the initial reaction has been more in line with the new policy orientations of the 1990s than with those in vogue in the previous 50 years.

These new attitudes began to surface in the late 1980s. In the early 1990s, some of their most articulate exponents became the economic ministers of many countries in Latin America. The international financial community was dazzled by this new breed of highly trained, charismatic leaders who used their frequent international road shows to sway investors. Moreover, investors had only to turn to their computer screens to confirm that the macroeconomic situation in Latin America was turning around and that stock markets there were becoming gold mines.

What the computer screens did not show, however, was the fragility of the underlying realities and the immensity of the tasks still remaining. While the initial stage of macroeconomic reforms was relatively easy to implement, the next stage--deeper institutional changes--was going to be harder and take much longer. Changing rules is always easier than changing organizations. Opening the stock market to foreign investors or eliminating subsidies can be done with the stroke of a pen and can have immediate results. Building the equivalent of a Securities and Exchange Commission or organizing a well-targeted social program to compensate the poor for the loss of subsidies requires complex organizational efforts that take much longer to bear fruit. In Venezuela, for example, the banking system was relatively easy to deregulate. Upgrading the regulatory framework was a much slower process, and that lag proved fatal. More than half the banks in the country failed because of massive corruption undetected by shoddy government supervision and because of economic instability resulting from misguided policies. The bank failures led to a bailout that was proportionally over 15 times larger than the United States' savings and loans crisis.

Latin America's institutional frailty remains a major bottleneck for the needed fundamental transformations. Enthusiastic portfolio investors, for example, paid scant attention to the fact that Latin America exhibits the lowest savings rates of any region and has yet to overcome many of the obstacles that hinder its capacity to compete abroad. Such political and economic handicaps lengthen the time needed for market reforms to bear fruit.

In Latin America, 46 percent of the population is poor. In 1994, one out of every five people in the region did not have the money to ensure an adequate daily diet. But Latin America is not only poor. It has also had the most uneven distribution of income in the world since data on the subject first became available in the 1950s. The percentage of income going to the poorest fifth of the population declined between 1950 and the late 1970s, well before the debt crisis and the market reforms of later decades. By the early 1990s, wealth was even more concentrated than in the early 1970s, with the richest 10 percent of households receiving 40 percent of the total income while the bottom 20 percent got less than 4 percent.

The explanations for the region's extreme poverty and inequality are many and varied, but inflation, stagnation, unemployment, the marginalization of indigenous populations, and public agencies' inability to provide even minimally adequate education and health care are key factors. The recent lowering of inflation and the resumption of economic growth has curbed the expansion of poverty that Latin America suffered in the 1980s. But the rate of growth has not been enough to reduce poverty. In 1993, the average income per person was five percent less than it was in 1980. According to the World Bank, the number of poor increases every year in which average regional economic growth falls under 3.4 percent. Moreover, regardless of how high growth rates may be, there is little hope of achieving much social progress unless the effectiveness of social welfare agencies is dramatically increased. This, in turn, requires major reforms in labor laws that now make it virtually impossible to rid the public sector of its severe organizational handicaps.

To sustain higher growth rates, Latin America's low domestic saving rates will have to increase significantly. On average, the high-growth countries of East Asia save 35 percent of their GDP. At about half that level Latin America's saving rates have been the world's lowest since the 1960s. The new trend toward price stability, fiscal balance, financial reforms, and privatized pension funds bodes well for a gradual increase in savings rates. In the meantime, however, Latin America's economic growth will continue to be overly dependent on capital repatriation and external financing, making the region's economies vulnerable to the vagaries of international financial markets.

The region's low savings rates are closely associated with low investment rates. Latin America has accumulated a gigantic backlog of investments in a wide variety of sectors. Just to cover pent-up demand in water and sanitation, telecommunications, power, and transportation, it needs to invest $60 billion each year for the next six years--about $1 billion each week The region's neglected manufacturing and agricultural sectors need massive investments to update their technology and increase productivity. The necessary money can only come from a combination of foreign investment and increased domestic savings.

Low productivity is at the core of the region's handicap in selling the exports it needs to sustain higher growth. While the reforms have clearly made Latin America more competitive than ever, the region's exporters still face major structural impediments to becoming world-class players. In Singapore, it takes 20 minutes for a cargo ship to clear customs and only a few hours to load or unload its freight. In most Latin American ports, the process takes days or even weeks. While Argentina or Peru may today be more competitive than ever, what really matters is how competitive they are with rival countries for shares of the world export markets. The region's exporters still face such hurdles as labor codes that stifle worker productivity, industrial plants designed to serve protected domestic markets, managers and bankers with little export experience, inadequate infrastructure, and poor public services.

In the 1950s, Latin America accounted for 12.5 percent of world exports. In 1990, it accounted for less than 3.5 percent of world trade--its lowest point in a century. Today, it is even behind the five percent share it enjoyed in the late 1970s. In contrast with East Asia, where the weight of commodities in total exports has declined sharply, from 90 percent in 1970 to less than 25 percent in 1995, commodities continue to account for over half of Latin America's exports.

But export performance not only depends on domestic factors. Access to export markets is another important requirement. The many free trade agreements in the hemisphere, the completion of the General Agreement on Tariffs and Trade's Uruguay Round and the creation of the World Trade Organization (WTO) are all good news for Latin American exporters. Other news is less good. Latin American exporters still face protectionist barriers in Europe, Japan, and the United States. At a time in which half of world trade takes place under the preferential conditions among members of regional trading arrangements, the Mexican crash has pushed the prospect for extending NAFTA to the rest of the hemisphere well into the next century. "I am not sure we are ready for more adventures," said Senator Daniel Patrick Moynihan (D-N.Y.) of the possibility of extending NAFTA to U.S. neighbors south of the Rio Grande.

After decades of protectionism, Latin American countries are betting their future on exports. While soaring intraregional trade saved the day for many exporters in the early 1990s, the hope was for a next, stage when more rapid expansion of extraregional exports anchored in free trade agreements with industrialized countries would become a stable engine of growth. That stage will have to wait. Export growth will continue to rely on intraregional trade and the expansion of exports to Europe, Asia, and the United States. Fortunately, world trade is expected to grow rapidly in coming years, and these three markets are becoming more open thanks to the Uruguay Round and the WTO.

It will be some years, however, before Latin American exporters will be able to enjoy the benefits of treaties designed to facilitate access to these markets. Despite the renewed European Union rhetoric about economic cooperation with Latin America, the EU's Common Agricultural Policy leaves very little room for meaningful trade agreements, given the importance of agriculture in Latin America's exports. Asia's interest in Latin America continues to be driven almost exclusively by its need to secure access to raw materials and agricultural commodities. In the aftermath of the Mexican debacle, even Chile--small, remote, and posing no significant threat to protectionist coalitions in the United States--faces an uphill battle for NAFTA membership.

This leaves countries like Brazil and Argentina with even dimmer hopes of joining NAFTA in the near future. Not that the Brazilians much care. They have repeatedly stressed that, for them, being "annexed" by NAFTA is less a priority than it was for Mexico. Brazil's dependence on the United States for export markets and portfolio inflows is much lower than Mexico's. Moreover, Mexico's willingness to accept many of the NAFTA conditions reflected its desperation to boost the confidence of the jittery foreign investors on whom Mexico had grown so dependent.

By default, dimmed hopes about NAFTA have brightened the prospects for Mercosur, a trade area formed by Argentina, Brazil, Paraguay, and Uruguay that, unlike NAFTA, has the EU as its main trading partner. The main threat to Mercosur's progress is a reversion of any of its larger members into protracted macroeconomic instability. Barring such relapses, deeper economic integration among a group of countries that accounts for 70 percent of the hemisphere's non-NAFTA economy and constitutes the largest customs union in the developing world certainly could become an important driver of growth. Mercosur can also become the base on which to build "SAFTA," a South American Free Trade Agreement. When the United States recovers from its Mexican disappointment, it will again be able to recognize that free trade with South America is indeed an important national priority. Argentina or Brazil--a country roughly the size of Russia in terms of its economy and population--might then be accorded at least as much attention as Haiti, Cuba, Panama, or Grenada.

This would be a welcome departure from the tradition of having more immediate hemispheric concerns and emergencies displace the largest South American countries from the U.S. agenda. In the 1960s and 1970s, the United States concentrated on dealing with Cuba and communist insurrections throughout Latin America. In the 1980s, the debt crisis and the Central American wars monopolized Washington's attention. During the early 1990s, economic reforms, NAFTA, and Haiti became the foci. In the second half of the 1990s, U.S. attention will probably be concentrated on ensuring that Fidel Castro's Cuba does not survive and then on lamenting the extreme costs to American taxpayers of the island's transition to democracy and free markets. Perhaps the United States will finally be able to focus on its other large neighbors to the south in the next century.

AFTER THE TEQUILA HANGOVER

THE WIDESPREAD euphoria about Latin America vanished overnight in the wake of the Mexican crisis. The current gloom about the region's futurethe Tequila effect--will so pass, albeit more slowly. After the hangover, a more sober, realistic view is ready beginning to emerge. The realization that Latin America is neither the promised land described in the promotional brochures of the early 1990s nor the wasteland depicted in the scathing articles prompted by the crisis will eventually sink in.

In coming years, Latin American governments will exhibit more diversity in their economic policies than in the last five. More segmented foreign investment inflows, differential export performances, and varied political cicumstances will affect both the pace of reforms and their specific emphasis in different countries. Nonetheless, in all countries the central challenge will be the same: to reconcile macroeconomic stability with quicker reductions of poverty and inequality. International financial markets are making it more difficult than ever to sustain protracted fiscal and monetary imbalances. Early this decade, achieving macroeconomic stability was enough to insure popular support for governments steering their countries out of long periods of crisis. But in the post-adjustment stage, macroeconomic miracles will not be enough to endear Latin governments to their voters. Democratization is making it more difficult than ever to sustain the traditional social imbalances. The patience of the poor and the middle classes is being eroded by the sluggishness of progress on the social front. The Chiapas uprising in Mexico and the recent revolts in Venezuela are dramatic reminders to Latin American politicians of the consequences of not moving fast enough against social inequities.

Retaining the region's newfound but still fragile macroeconomic equilibrium requires new ways of funding public **expenditures** as well as major redirections of government spending. For instance, public money now going to public universities, the **military**, or urban infrastructure will have to be reallocated to primary education, preventive health care, and rural communities. As income from privatization will no longer be the main source official revenues, the tax base should be expanded. For the first time in **Latin America's** history, property taxes should be more than a symbolic source of public revenues. These measures are as obvious as they are politically difficult to adopt, but keeping them out of public debate will become increasingly onerous.

Another area that will pose unprecedented challenges for Latin American governments is their interaction with the global economy. Finding exchange-rate regimes consistent with both new international financial realities and domestic macroeconomic constraints will continue to be a difficult puzzle. The current wariness about the risks of foreign portfolio investment will have to be reconciled with the fact that without such investments, access to the largest pool of global capital now available will be severely curtailed. Access to export markets will continue to be a critical factor, but in contrast to the early 1990s, the fortunes of Latin American exporters may be determined more by free market reforms made in Brasilia than in Washington.

The biggest challenge of all, however, will be to build the institutions needed to anchor the reforms of the last five years so social reforms can progress further and faster. From antitrust commissions to schools, from banking supervision boards to rural health delivery units, the desperate need for better institutions runs the gamut of public tasks. Many of these institutions already exist. Some are even quite old and boast all the trappings of modernity. Yet too often they are mere facades that cannot perform the functions for which they were created. "So many words have acquired lesser meanings in Argentina: general, artist, journalist, historian, professor, university, director, executive, industrialist, aristocrat, library, museum, zoo; so many words need inverted commas," the author V. S. Naipaul has written. Unfortunately, throughout Latin America, the inverted commas also apply to institutions like "Ministry of Education," "Child Nutrition Board," and "Technological Research Institute." The central challenge for Latin America is to get rid of the inverted commas. Building effective institutions will mark the difference between instant but perhaps passing reforms and those that are sustainable and more permanent. In the future, neither governments nor investors will be able to afford the luxury of superficiality they enjoyed in the early 1990s. Governments will have to go beyond issuing sweeping decrees and worry more about the details that make institutions work, and investors will have to look deeper into the countries in which they invest and learn to differentiate among them.

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